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SUBJECT: THE GOF TURNS TO DEFICIT CUTTING

¶1. (SBU) SUMMARY: Although part of the Sarkozy team's campaign platform, fiscal adjustment was put on the back burner in favor of other reform priorities following the 2007 elections. Now under considerable budgetary pressure, the GOF has ruled out further tax cuts (with an exception for reform of the professional tax and the elimination of a corporate tax) and reiterated its commitment to eliminate the budget deficit by 2012. But a stalled economy and the impact of the August 2007 tax package will knock the GOF from its intermediate deficit target in 2009, despite efforts to rein in spending, eliminate fiscal incentives and fight tax fraud. The difficult budgetary environment will raise the bar for GOF overseas engagements that impose new spending commitments. END SUMMARY.

ELIMINATING THE BUDGET DEFICIT BY 2012

¶2. (U) In recent interviews Economy Minister Lagarde has said her fiscal priority through 2012 is to eliminate the public deficit, not lower taxes. The government hopes to reduce the budget deficit to 2.5 percent of GDP in 2008 and 2.0 percent in 2009, on its way to balance (and a reduction in public debt from 63.9 percent to 60.0 percent of GDP) by 2012. The 2007 government budget deficit (central government, social security system and local authorities) was a higher-than-expected 2.7 per cent of GDP, and the deficit has been running above forecast for the first half of 2008.

ELIMINATING FISCAL INCENTIVES, REFORMING BUSINESS TAXES

¶3. (U) In a move to increase revenue Lagarde has proposed eliminating (on a case by case basis) a range of existing tax incentives estimated to cost the budget 5 billion euros annually. Although the GOF has not specified the targeted measures, exemptions for investing in France's overseas territories and tax breaks for investing in rental properties are among those most frequently mentioned. Lagarde has defended exemptions from the wealth tax (France's tax on households with assets over 750,000 euros) for investments in small business, a measure introduced by the Sarkozy government in 2007.

¶4. (U) Lagarde has proposed eliminating a flat rate tax (l'imposition Forfaitaire Annuelle ou IFAO) currently imposed on businesses with annual sales of over 300,000 euros (paid on top of top of the

corporate income tax). And she says the government plans to reform the controversial Qprofessional tax as early as September. (Note: An important source of revenue for local authorities, the professional tax is based largely on a companyQs fixed assets and varies from region to region. End note) A Ministry of Finance budget document has described the tax as Qthe most harmful tax for economic growth and competitiveness of the economy.

FIGHTING TAX FRAUD

15. (U) The GOF is putting renewed emphasis on the fight against tax fraud, which is estimated to have cost the government 29 - 40 billion euros annually over the past several years. (Note: The government budget deficit in 2007 was 51 billion euros. End note.) Budget Minister Woerth has proposed creation of a special judicial unit, to be placed under the authority of a judge, that would specialize in tax fraud investigations. In early 2008 Woerth oversaw the creation of the National Delegation for the Fight Against Fraud (DNLF), a structure designed in part to serve as a clearinghouse for improving coordination among public institutions in the fight against fraud.

ECO-TAXES IN, JUNK FOOD TAXES ON THE HORIZON?

16. (U) Following its broad-based 2007 consultative forum on environmental policy -- the "Grenelle de lQEnvironnementQ-- the GOF introduced a system of financial rewards and penalties (Qbonus/malusQ) to

PARIS 00001626 002 OF 003

steer consumers towards low-carbon emission automobiles. The program has been popular and Minister for Sustainable Development Borloo says average emissions for new vehicles sold have dropped nine percent in the eight months of the programQs existence. But demand for heavily-polluting vehicles has proven more elastic than expected, and a program that was designed to be revenue neutral has cost the government 140 million euros. Borloo now wants to extend the Qbonus-malusQ system to other goods in 2009 (including refrigerators, light bulbs and flat screen computers). Finance Minister Lagarde and Budget Minister Woerth are pushing back, arguing that the government should tax polluting goods rather than provide payment for use of environmentally-friendly products.

17. (U) Woerth has also teamed up with colleagues to look at other tax policy options for correcting perceived market failures and boosting revenue. The GOF has considered a tax on trucks transiting France indexed to distance travelled, a measure that could bring in 1 billion euros a year by 2010. And together with Health Minister Bachelot Woerth commissioned a study of possible measures to fight obesity, cardiovascular diseases and cancers. Government staff recommended boosting the VAT rate from 5.5 to 19.6 percent on mass market food stuffs deemed "too rich, too sweet, too salty and not strictly necessaryQ (including pizzas, hamburgers and sandwiches). In the end the GOF delayed a decision out of concern for penalizing Qthe most underprivileged population, who eat badly,Q and in light of the inauspicious inflationary environment.

CUTTING THE HEALTH INSURANCE DEFICIT AND FUNDING PENSIONS

18. (U) The government says elimination of FranceQs national health insurance system deficit is essential to achieving a balanced budget by 2012. Budget Minister Woerth told the press the deficit would

increase 2.0 billion euros per year if steps weren't taken to rein in spending. To trim the current 4.1 billion euro deficit the government plans to raise 1 billion euros per year by increasing a tax on sales of health insurance and mutual insurance companies that provide top-up cover to the national health insurance system. The government will also try to curb over-prescription of medication, and reduce reimbursements for x-rays, blood tests and hospital transport. The government has ruled out increasing the Contribution Sociale Generalisee (CSG), a tax on all forms of income devoted to funding France's broad welfare system (social security). But it plans to extend the tax to include profit-sharing in income already subject to the CSG, a proposal that has drawn the ire of the business community.

¶9. (U) To cover pension shortfalls the government plans to increase payroll taxes by 0.3 percentage points on January 1, 2009 and 1 percent point by 2011 (in addition to steps taken to extend the retirement age). The increase would be offset by an equal cut to the unemployment insurance contribution. The Unemployment Insurance Fund (UNEDIC), which collects the contribution, is currently in surplus thanks to a drop in unemployment.

RATIONALIZING PUBLIC SPENDING

¶10. (U) The government initiated a general revision of public policies a year ago under the direction of Budget Minister Woerth to improve the efficiency of the public sector and rationalize spending. Initial results from the process will be reflected in the 2009 budget (due on September 24), and in a first-time multi-year document laying out budget prospects for 2009 to 2011. Spending increases will be capped at the inflation rate and 30,600 civil servant positions will be cut by attrition in 2009. Given constraints imposed by non-discretionary items (debt service, pensions, local government transfers, EU contributions), the government has indicated that

PARIS 00001626 003 OF 003

it will favor education and research, among other priorities, in its 2009 budget.

COMMENT

¶11. (SBU) The economic slowdown will further constrain the government's already limited budgetary maneuvering room, and make the goal of a balanced budget by 2012 that much more difficult to achieve. The government is clearly serious about holding the line on expenditures. The pressure to limit discretionary spending will remain a strong back-story to any effort at boosting French international engagement that involves new spending commitments. Over the longer term the Sarkozy government's proposed measures are likely to improve France's fiscal health, and some tax reforms (including to the professional tax and the CICE) may help boost competitiveness. But with general government spending still accounting for well over 50% of GDP, real fiscal consolidation will require stronger action on the expenditure side, possibly to include reform of France's multilayered, and expensive system of regional and local government.

PEKALA